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RISK MANAGEMENT AND INTERNAL CONTROL DISCLOSURE AMONG MALAYSIAN LISTED ISSUERS

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ABSTRACT

Over the years, firms have been pressured by various stakeholders to be transparent about how they operate. In this regard, good corporate governance should ensure timely and accurate disclosure is made on a firm's financial, risk management and internal control. Hence, the purpose of this study is to construct an index for risk management and internal control. This index used to assess the extents of Malaysian listed firms' compliance of the risk management and internal control guidelines created for directors of listed issuers. The index was developed based on the requirements, under Paragraph 15.26(b) of Bursa Malaysia Securities Berhad's Main Market Listing Requirements ('Listing Requirements'), as guided by the 'Statement on Risk Management and Internal Control: Guidelines for Directors of Listed Issuers'. This guideline, which was released on 31 December 2012, incorporates the revision made to the Statement on Risk Management & Internal Control: Guidelines for Directors of Listed Issuers (issued in 2000). The findings of this study reveal that the compliance score by the sample firms reach about 70 per cent. The result is beneficial to the industry led Task Force to ascertain how the revised guidelines were incorporated into corporate governance disclosure. The findings of this study could also be useful for firms to determine the adequacy of their risk management and internal control practices and ensure that these guidelines are communicated appropriately and effectively. This, in turn, will assist firms to achieve their corporate objectives and match stakeholders' expectations within an ethical and healthy corporate culture.

Keywords: Disclosure, internal control, risk management

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INTRODUCTION

Effective risk management and effective internal control are crucial as they assist organizations to better understand the risks and for the board to portray good stewardship. In the meantime, firms are increasingly being pressured by various stakeholders to play a leading role in risk management and transparently report how they operate. Consequently, good corporate governance would ensure that shareholders and other stakeholders are well informed about the principal risks and prospects of the company.

Firms that deal with many investment and financial decisions expose themselves to a number of risks. These risks, which could affect their competitive advantage, could be due to many factors but importantly, much of the risks can be controlled through the management's internal decision making. Essentially, risk management requires a practice of identifying potential risks in advance to mitigate its adverse effect including loss of opportunities and reputation. This so called risk management requires a practice of identifying potential risks in advance, analyzing its effect to the business and establishing a program to mitigate the adverse effect of the risks. On the other hand, though the word 'risk' may carry negative connotations of unexpected problems, it has opened more opportunities for organizations to innovate and discover new ideas and approaches in managing the business. Therefore, the board of directors and line managers should be conducting active risk management discussions on the issues concerned at multiple forums to ensure that the risks do not have any adverse effect to the firm's value.

The driving forces for risk management can be viewed from two different perspectives. First, firms incorporate risk management strategies to increase firm's value and to maximize shareholders' wealth. Second, opportunistic managers whose interest is diverted from the shareholders' would undertake the risk management strategies to protect their own wealth. However, regardless of these forces, the strongest motive would always to avoid financial distress and to ensure the shareholders' interest is being protected (Fatemi & Luft, 2002).

In this light, the board of directors is responsible to establish a sound framework for risk management to determine the firm's level of risk

tolerance, assess and monitor risks, review the firm's internal control and periodically, test the adequacy and effectiveness of the system. The scope of risk management is not only to discuss the risk management issues, but the board must ensure that proper measures are taken to raise the issues to the board for decision making process, identify mitigating measures and determine its impact across business units and functions. Inherently, the success of risk management occurs when it is embedded into the firms' corporate culture

In recent years, firms have been pressured by various stakeholders to be transparent about how they operate, hence, good corporate governance means that timely and accurate disclosure is made in regards to financial, risk management and internal control, as well as, in corporate responsibility. An active information flow from the firm to the wider stakeholders is crucial as it ensures greater transparency and effective corporate governance.

Concurrently, firms are able to gain and retain trust and confidence from the customers, employees, shareholders and the wider stakeholders by being transparent. In simple terms, transparent means providing others with the truth be. This illustrates 'full disclosure', where active information flow from the firm to the wider stakeholders. In this light, good communication and an effective flow of information is crucial to ensure greater transparency as it sends a clear signal to investors and other stakeholders that the firm is practicing a transparent and healthy reporting exercise.

In tandem with this, the purpose of this paper is to construct an index known as RiMIC (Risk Management and Internal Control). This index will be used to assess the extents of listed Malaysian firms' compliance to the Statement on Risk Management & Internal Control – Guidelines for Directors of Listed Issuers (hereafter referred to as "The Statement"). This, in turn will assist firms to achieve their corporate objectives and meet the stakeholders' expectations within an ethical and healthy corporate culture.

BACKGROUND OF THE STUDY

A revision to the Guideline on the Statement of Risk Management and Internal Control effective on 31 December 2012 obliges firms to implement

sound risk management strategies. As an important regulatory tool, the guideline is intended to guide directors on the disclosure of the firm's risk management and internal control system. This is because the disclosure of information reduces the gap of knowledge, which is known as asymmetric information, between the insiders and outsiders. Dionne and Ouederni (2011) reported that risk management reduces asymmetric information problem as investors or creditors are aware of the approaches undertaken by the management in managing their funds. Furthermore, the importance of risk management was a central issue in the Cadbury Report in 1992, followed by the Hampel report in 1998 and Turnbull Report in 1999 which emphasized the combined code where risk management become part of the internal control.

Several past studies have examined risk management disclosures of listed firms in Malaysia; Ismail and Rahman (2013) examined the risk management disclosure level among top 150 public listed firms in Malaysia as mandated by the Financial Reporting Standard No 132 (FRS132): Financial Instruments: Disclosure and Presentation, while Rahman, Kighir, Oyefeso and Salam (2013) investigated the level of compliance with twelve Financial Reporting Standards (FRS) disclosure requirements for firms listed on Bursa Malaysia in 2008. Taking a slightly different approach, this research examined the level of risk management and internal control disclosure with specific reference made to the 'Statement on Risk Management and Internal Control: Guidelines for Directors of Listed Issuers'. As there are still very limited studies conducted in this area, this research will shed additional light into this niche area. Moreover, identifying the state of risk management disclosure will assist the policy makers to assess the effectiveness of corporate governance structure in Malaysian firms (Xiaoyan, 2013).

The Statement on Risk Management and Internal Control

The Statement on Internal Control - Guidance for Directors of Public Listed Firms was initially issued in December 2000 to assist firms in formulating the Statement on Internal Control in their annual report in accordance with Bursa Malaysia's Listing Requirements. In 2012, the Statement on Risk and Management & Internal Control: Guidelines for Directors of Listed Issuers had replaced the previous guideline; the

current guideline is intended to guide directors of listed issuers in making disclosures concerning risk management and internal control in their firms' annual reports pursuant to paragraph 15.26(b) of the Listing Requirements. The guidelines have outlined the management's and the board of directors' obligations, with respect to risk management and internal controls. It also provides guidance on the key elements needed in maintaining a sound system of risk management and internal control, as well as describing the process that should be considered in reviewing its effectiveness.

The revised guidelines also referenced the revised Malaysian Code of Corporate Governance (MCCG), which was issued in March 2012. Recommendation 6.1 of the Code states that the board should establish a sound risk management framework and internal control system, hence, the commentary to the recommendation provides guidance to the listed issuers where:

1. The board should determine the company's level of risk tolerance and actively identify, assess and monitor key business risks to safeguard shareholders' investments and company's assets;
2. The board should be committed to articulating, implementing and reviewing the company's internal control system;
3. Periodic testing of the effectiveness and efficiency of the internal controls procedures and processes must be conducted to ensure that the system is viable and robust; and
4. The board should disclose in the annual report the main features of the company's risk management framework and internal control system.

There are numerous empirical evidences on risk disclosure that vary in terms of their objectives and method of analysis. The evidences are generally focused on the extent of compliance with the disclosure guideline and investigating factors that influence the level of disclosure. Amran, Rosli and Hassan (2009) performed a content analysis to determine the extents of risk disclosure in 100 listed firms' annual reports and found that strategic risks at the top rank were reporting (97%) followed by operations risk (96%) and empowerment risk (82%). Other disclosures include financial

risk (64%), integrity risk (58%) and information and technology risk (50%). In the meantime, Othman and Ameer (2009) investigated whether firms disclosed financial risk management objectives and policies in the annual reports; their findings revealed that not all firms disclosed such information, where second board listed firms contributed to the highest non-compliance at 31.46 followed by firms on MESDAQ 30.35% and on the main board 17.10%. The study also indicated that interest rate disclosure was the most mentioned category while credit risk was the least mentioned category. Ismail and Rahman (2013) conducted a study on risk management disclosure by 150 top Malaysian listed firms in reference to the Malaysian Financial Reporting Standards (MFRS) 132 Financial Instrument: Disclosure and Presentation. The findings indicated the mean score of 52.79%, which show that a majority of the firms had provided risk management disclosure. The mean score according to two types of disclosures: a) mandatory and b) voluntary and this showed that mean score for mandatory disclosure was 70.56%, while the mean score for voluntary disclosure was 49.83%. The plausible reason for this low percentage of disclosure could be due to its non-mandatory nature.

Hence, this current study will assist the regulators by providing insights into the understanding of the current state of the disclosure on risk management and internal control. This will consequently enhance reporting and quality disclosure to ensure that shareholders and other stakeholders are well informed about the principal risks and the prospects of the firm.

RESEARCH METHODOLOGY

There are two parts to this study. First, this study constructs an index known as *RiMIC* (Risk Management and Internal Control), which is based on the requirement under Paragraph 15.26(b) of the Main Market Listing Requirements ('Listing Requirements') of the Bursa Malaysia Securities Berhad. According to Paragraph 15.26 (b), a listed issuer must ensure that its board of directors makes an additional statement about the state of internal control of the listed issuer, as a group, in the annual report. Therefore, this index is beneficial as it assists in the analysis of the disclosure level of the sample firms. Second, *RiMIC* was used to assess the extent of listed Malaysian firms' compliance to the risk management and internal control guidelines for directors of the listed issuers.

Measurement Procedures

To Construct an Index for Risk Management and Internal Control

The disclosure index measures the level or degree to which a firm discloses the items studied (Al Mutawaa & Hewaidy, 2010). In this light, there are two methods that have been widely used to construct a disclosure index, the weighted and the unweighted disclosure index. The weighted method is always being criticized due to its subjectivity in the ranking of the relevance of the item studied. On the other hand, the un-weighted disclosure index is preferable in this study since the sample firms were randomly chosen and free from any specific firm characteristics, such as, authorized capital, manufacturing intensive and others. Here, an item was scored one (1) if disclosed and zero (0) if otherwise. This disclosure index is calculated based on the ratio of the total items, as disclosed by a sample firm, to the maximum possible number of items that can be scored by that sampled firms.

To Assess the Extent To Which Listed Firms in Malaysia Comply With the Statement on Risk and Management and Internal Control (Guidelines for Directors of Listed Issuers)

The ‘Statement on Risk Management and Internal Control: Guidelines for Directors of Listed Issuers’ serves as the starting point achieve the objective of this study. The guidelines provide a listing comprise of 42 paragraphs which the board could consider asking when carrying out its annual assessment. These included questions on (i) assessing the risk management framework (ii) control environment and control activities, (iii) information and communication, and (iv) monitoring. Nevertheless, this study merely focuses on the narrative statements of the disclosure on the risk management and internal control that comprised of ten (10) sub paragraphs of paragraph 41 and 42. These ten (10) sub paragraphs of paragraph 41 and 42 (refer Table 1) were selected because they emphasize the important aspects of a sound risk management and internal control system, which include the main features, the risk management and internal control processes and their effectiveness, as well as, the responsibility of the board in providing assurance of risk management and internal control system in place. Specifically, the guidelines require disclosure on the adequacy of risk management and internal control system that is in place, as well

as, the assurance of its effectiveness provided by the board. However, the scope of this research is merely focused on the Board’s Statement on Risk Management and Internal Control to cater to the requirement pursuant to paragraph 15.26(b) of Bursa Malaysia Listing Requirements. Inherently, this paragraph specifically mentions the board’s responsibility in disclosing the internal control practices in the annual report.

In this regard, the Statement on Risk Management and Internal Control- Guidelines for Directors of Listed Issuers, has a total of 42 paragraphs which encompass a broader coverage on the subject including elements of sound risk management and internal controls system, roles and responsibilities for risk management and internal control, process for reviewing the effectiveness of risk management and internal control, as well as the Board’s Statement on Risk Management & Internal Control. This study limits the research scope to only the disclosure made in the Board’s Statement on Risk Management and Internal Control. Hence, all the sample firms’ Statement on Risk Management and Internal Control were evaluated against the following disclosure requirements.

**Table 1: List of items for *RiMIC*
(Risk Management and Internal Control Index)**

No	Item	Yes	No
“The main focus of the required disclosure is with regards to.....”			
1.	The main features assessed of the company’s risk management and internal control system;		
2.	The ongoing process for identifying, evaluating and managing the significant risks faced by the company in its achievement of objectives and strategies;		
3.	That such process has been in place for the year under review and up to the date of approval of this statement for inclusion in the annual report;		
4.	The process it (or where applicable, through its committees) has applied in reviewing the risk management and internal control system and companying that necessary actions have been or are being taken to remedy any significant failure or weaknesses identified from that review;		
5.	That a review on the adequacy and effectiveness of the risk management and internal control system has been undertaken;		

No	Item	Yes	No
6.	Commentary on the adequacy and effectiveness of the risk management and internal control system;		
7.	The process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and financial statements; and		
#.	Does the company have any joint ventures or associates? <i>*This question is created to assist in the evaluation of the subsequent disclosure.</i>		
8.	Where material joint ventures and associates have not been dealt with as part of the group for the purposes of applying these guidelines, this should be disclosed.		
9.	In its narrative statement, the board should also include whether it has received assurance from the CEO on whether the company's risk management and internal control system is operating adequately and effectively, in all material aspects, based on the risk management and internal control system of the company.		
10.	In its narrative statement, the board should also include whether it has received assurance from the CFO on whether the company's risk management and internal control system is operating adequately and effectively, in all material aspects, based on the risk management and internal control system of the company.		

Population and Sample

The data were obtained by examining annual reports of listed firms on the main market of Bursa Malaysia. Financial services firms were excluded from the sample as they are separately governed by the Central Bank (Bank Negara Malaysia). Year 2013 was taken as the sample period to ascertain compliance with the disclosures required by the Statement on Risk Management and Internal Control: Guidelines for Directors of Listed Issuers that was released on 31 December 2012.

From the 819 firms listed on the main market of Bursa Malaysia (retrieved from Bursa Malaysia website as at 11 February 2014), 114 firms were selected using stratified sampling based on their industries as shown in Table 2. The stratified sampling process in this study was conducted by identifying the types of listed industries if all Malaysian-listed firms as shown in the Bursa Malaysia website. In all, 8 categories of industries were found. However, construction, technology, mining and plantation industries

were clustered together due to the small population size. Next, these 819 firms were filtered based on the availability of 2013 annual report at the time the data was collected (as at 16 February 2014) This is consistent with the approach undertaken by Abdullah, Evans, Fraser and Tsalavoutas (2015). This had reduced the population to 280 firms. Finally, the final sample size of 114 firms was randomly chosen, without considering the firms' characteristics limitation such as capital structure, etc.

Table 2: List of Industries for the Study

No.	Industry	Population	No. of companies with available annual report 2013 (As at 16/2/2014)	Sample selection (Year end 2013)
1	Consumer products	141	61	22 (19.3%)
2	Industrial products	287	93	28 (24.6%)
3	Properties	101	44	20 (17.5%)
4	Trading/services	224	56	20 (17.5%)
5	Others (Constructions, technology, Mining and Plantation)	66	39	24 (21.1%)
	TOTAL	819	293	114 (100%)

FINDINGS

Sub paragraph 1 of paragraph 41 focused on the disclosure on the main features of the company's risk management and internal control system. The main features include the internal audit function, risk management framework, the information and communication control, the delegation of the responsibility and monitoring process. The finding indicates that all the sample firms (100% or 114 firms) had disclosed all of the main features of the company's risk management and internal control system in their annual reports.

Meanwhile, sub paragraph 2 of paragraph 41 indicates the disclosure with regard to the ongoing process for identifying, evaluating and managing the significant risks faced by the firm in its achievement of objectives and

strategies. Based on the study, 96% had disclosed this process, but it is also important to highlight here that this does not mean that the remaining 4% (or about 5 of sample firms) do not have any ongoing process for identifying and managing the significant risk in place. This simply indicates that these firms did not disclose the ongoing process undertaken to identify and manage risks.

Sub paragraph 3 of paragraph 41 is a continuation of sub paragraph 2 of paragraph 41 where the disclosure that the process that has been in place for the year under review and up to the date of approval of this statement for inclusion in the annual report is required. In this study, disclosure is considered to occur when, the firm discloses that it has conducted the ongoing process, and that such process has been in place for the year under review with up to the date approval of the statement included in the annual report. The findings revealed that 75% (86 sample firms) had disclosed such information.

Sub paragraph 4 of paragraph 41 is about the process that the firm, or where applicable, its committees, has applied in reviewing the risk management and internal control system as well as in confirming that the necessary actions have been or are being taken to remedy any significant failures or weaknesses identified from that review. Based on the analysis, only 55% (63 sample firms) had disclosed such information.

Sub paragraph 5 of paragraph 41 ensures that the disclosure on the review of the adequacy and effectiveness of the risk management and internal control system has been undertaken. Based on the findings, majority of the sample firms (96% or 110 firms) had disclosed this information.

Meanwhile, sub paragraph 6 of paragraph 41 requires firms to disclose a commentary on the adequacy and effectiveness of the risk management and internal control system. More than half of the sample firms (54% or 62 firms) had disclosed this information. In this light, disclosure occurs when the sample firms provide a commentary or detailed explanation about the internal control and risk management process and not just simply mention the elements of the internal control. Some firms have shown strict adherence to the Guidelines as they had provided detailed commentary as well as diagram, framework and detailed process of the internal control system.

Sub paragraph 7 of paragraph 41 requires firms to disclose the process it has applied to deal with material internal control aspects of any significant problems disclosed in the annual report and financial statements. It was found that 61% (70 sample firms) had disclosed this process. In the meantime, sub paragraph 8 of paragraph 41 demands disclosure in form of firms that have any joint ventures or associates to disclose about the material joint ventures and associates that have not been dealt with as part of the group for the purposes of applying these guidelines. Analyses show that out of 114 firms, 39 firms have joint ventures or associates and from this number, 26% (10 sample firms) had disclosed this issue with regard to material joints ventures or associates.

Moreover, sub paragraph 1(a) of paragraph 42 requires the board to disclose in the narrative statement that it has received assurance from the CEO on whether the firm’s risk management and internal control system is operating adequately and effectively in all material aspects, based on the firm’s risk management and internal control system. The CEO, as the most senior corporate officer plays a very important role to build a climate of trust by providing such assurance, as reported by Bazrafshan, Kandelousi and Hooy (2016). Based on the findings, 84% (96 sample firms) had disclosed that the CEO has provided such assurance while the remaining 16% (18 sample firms) had simply stated that the board (without specifically mentioning the CEO) has provided assurance with regard to the adequacy and effectiveness of the internal control and risk management system.

Finally, sub paragraph 1(b) of paragraph 42 requires the board to disclose, in a narrative statement, that it has received assurance from the CFO on whether the company’s risk management and internal control system is operating adequately and effectively in all material aspects, based on the risk management and internal control system of the company. Based on the findings, 71% (81 sample firms) had disclosed that the CFO had provided such assurance.

Table 3: Descriptive Statistics of Risk Management and Internal Control Compliance Score

	N	Minimum	Maximum	Mean
CS	114	0.3636	1.0000	0.7065

*CS = Risk Management and Internal Control Compliance Score

Table 3 shows the descriptive statistics of risk management and internal control compliance score for the 114 sample firms. Based on the analysis, it indicates that the minimum level of disclosure was 36.36% (about 4 items out of 10 items in the guideline) while the maximum level of disclosure was 100% (i.e. all 10 items in the guideline are disclosed in the report). Consequently, the average level of disclosure was 70.65% (i.e. about 7 to 8 items disclosed). The findings of this study is not much different with the study conducted by Ahmad, Abdullah, Jamel and Omar (2015) that reported the disclosure level for risk management and internal control for listed firms in Malaysia was about 69.99%. Ismail and Rahman (2011) also reported quite similar results. This reflects a good compliance level among the listed issuers.

DISCUSSION AND CONCLUSION

The guidelines set out the management’s and the board of directors’ obligations with regard to risk management and internal control. This is to ensure that a sound system is in place and can protect the shareholders’ interest. This, in turn, will help the firm to achieve its performance and profitability targets. It also promotes good corporate governance system that will lead to strong and balanced economic development.

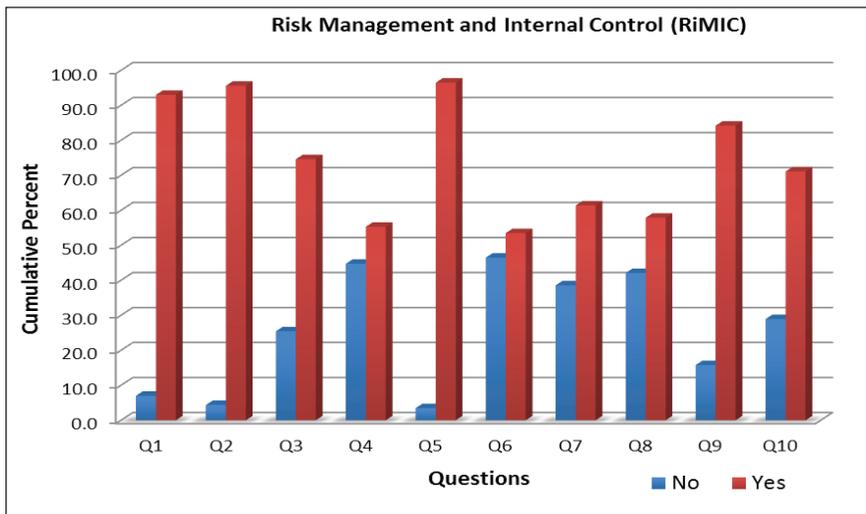


Figure 1: Summary of the Guideline Scores

Based on Figure 1, it can be concluded that the sample firms' compliance to the Guideline on the Statement of Risk Management and Internal Control is considered good, since the compliance to all sub paragraph disclosures were above 50%. Sub paragraph 5 of paragraph 41 which illustrates the disclosure on the adequacy and effectiveness of the risk management and internal control system by the sample firms showed the highest percentage at 96.5%, which implies that almost all sample firms had adequately disclosed their risk management and internal control system review.

On the other hand, sub paragraphs 4, 6 and 8 of paragraph 41 (Questions 4, 6 and 8 respectively) were plausibly the reason that decrease the disclosure to 70%. Despite the majority of the sample firms (96%), had disclose the ongoing process of identifying and managing risk, only 55% disclosed that necessary actions were taken to remedy the weaknesses. The possible causes for these findings could be due to the high awareness among the sample firms on the effort to disclose the ongoing process for identifying and managing the significant risk. However, only about half of these sample firms have yet to confirm the necessary actions to remedy any internal control weaknesses. This could suggest that about half of the sample firms are still not sure whether they want implement the necessary actions to mitigate any internal control failures.

Similar issue can be dictated for sub paragraph 5 of paragraph 41, as 96% of the firms said that they had reviewed the adequacy and effectiveness of the system but only 54% of the firms disclosed their comment on that adequacy. A comparison was made between the finding of this research and the findings from a study on corporate governance disclosures in the annual reports (for financial year end financial year end 31 December 2012 to 30 June 2013) which involved 300 issuers listed on the Main and Access, Certainty, Efficiency (ACE) markets. The analysis of corporate governance carried out by Bursa Malaysia on principle 6, is similar to this report except that Bursa had assessed on the revision from external auditor and excluded disclosure on material joint ventures, hence, while there are some differences in the percentage reported in this study, this could be due to number of sample; as Bursa Malaysia had a sample of 300 listed firms while this study only reviewed a sample of 114 listed firms.

The overall findings from the report carried out by the Bursa Malaysia, however, indicates that the disclosure level of the listed firms is still at an unsatisfactory level; The Bursa Malaysia reported that only 46% of the firms disclosed their comment on the adequacy of the risk management and similar outcomes (percentage is unknown), and this could imply that the listed firms have no detailed strategy and no intense actions in managing risks in the firms. However, based on 114 sample firms, this current study found that 54% of the firms disclosed comments on the adequacy and effectiveness of the risk management and internal control. However, this finding should be interpreted with caution as there could be possibility that these sample firms have sound risk management and internal control system but they chose to remain silent about these disclosures. Nevertheless, a greater sample size will be more representative of the population (Sekaran, 2003).

With reference to the extent of compliance to the Paragraph 15.26(b) of Bursa Malaysia Securities Berhad's Main Market Listing Requirements, it can be concluded that about 70% of the firms comply with the requirements. This can be considered acceptable as this is the first attempt for these firms in providing reports in regards to the new requirements. In addition, the findings contribute to the existing literature on risk management and internal control, particularly in the Malaysian context as this practice has not reached its maturity stage yet. It is expected that a strong positive response could be achieved with more time allocation and larger sample size for study.

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